Revenue Generating Activities for Nonprofits

This publication discusses legal issues that may arise when a tax-exempt organization engages in revenue generating activities, including income tax considerations, mitigating liability, structuring options, and taking on investors. This publication is intended to provide an overview of issues an organization should consider before launching a new revenue generating activity.

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This publication should not be construed as legal advice. Please contact an attorney if you need legal advice about any of the topics discussed in this publication.

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Introduction

Can nonprofits have activities that generate income?

Yes. Many nonprofit organizations[1] successfully maintain activities that generate income for the nonprofit, which can then be used to fund part of their operations. However, there are important legal and practical considerations a nonprofit should consider before launching such activities.

Examples of revenue generating activities include renting out unused office space, selling t-shirts, operating a café, or licensing an educational program to nonprofit educational institutions. In addition to raising money for charitable programs, revenue generating activities may also serve to advance a nonprofit's mission. For example, a museum may further its mission by selling educational objects in its gift shop; a health care clinic may advance its mission of improving health in the community by selling a diabetes cookbook; or a nonprofit focused on at-risk youth may start a house painting business to give youth job experience.

For the purposes of this guide, the term "revenue generating activities" does not encompass "exempt function income" – that is, reasonable fees charged by the nonprofit to participants in charitable programs, such as below market rent charged to low-income individuals in affordable housing or tuition at a preschool. Further, unlike traditional fundraising where funds are solicited from the public, in a revenue generating activity, money is earned through the nonprofit by offering a good or service in exchange for a fee.[2]

A note about "social enterprise": The term "social enterprise" is often used when discussing revenue generating activities that also promote a social or environmental cause. However, "social enterprise" is a broad, largely undefined concept that generally refers to the use of commercial strategies to maximize improvements in social and environmental well-being. Social enterprise often includes activities beyond revenue generating activities by nonprofit organizations—for example, business activities of a for-profit that aim to serve a social objective while making a profit. To avoid confusion, this guide uses the term "revenue generating activities" and focuses on legal issues that arise when nonprofit organizations use commercial activities to earn income, rather than the broader term "social enterprise."

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[1] The term "nonprofit" generally refers to an organization's corporate classification under the laws of its state of incorporation – in California, the most common classification would be a "nonprofit public benefit corporation" under section 5110 et seq. of the California Corporations Code. The term "tax-exempt" refers to an organization's income tax status under federal and state tax codes. Although not all nonprofit corporations are tax-exempt, this guide is written for nonprofit corporations operating in California that have obtained tax-exempt status under section 501(c)(3) of the Internal Revenue Code and section 23701(d) of the California Revenue and Tax Code. This guide sometimes refers to such organizations generally as "nonprofit organizations" and "nonprofits." When specifically discussing laws related to federal tax-exempt status, this guide may also use the term "501(c)(3) organization."
[2] For more information on laws relevant to conducting a charitable fundraising program, *see generally Anatomy of a Fundraiser: A Legal Guide for Charitable Fundraising in California*, Public Counsel (January 2020), https://publiccounsel.org/publications/anatomy-of-a-fundraiser-a-legal-guide-for-charitable-fundraising-in-california/.

What should a nonprofit consider before starting a revenue generating activity?

While revenue generating activities are a great way to raise money for a nonprofit and to further an organization's mission, there are important legal and practical considerations a nonprofit should consider before launching such activities. Specifically, a nonprofit organization needs to consider:

(1) whether income generated by the activities would be taxable;

(2) whether the nonprofit could lose its tax-exempt status by engaging in the activity;

(3) how the nonprofit can minimize its liability stemming from the new activities; and

(4) whether the activities should be operated within the nonprofit or within a wholly or partially owned subsidiary.

Each of these will be discussed below.

Income Tax Considerations – Unrelated Business Income Tax (UBIT)

What is the Unrelated Business Income Tax?

Nonprofit organizations exempt under section 501(c)(3) normally do not pay income tax.[3] However, 501(c)(3) organizations may be required to pay tax on income derived from a regularly carried on trade or business if the activity is not substantially related to the organization's exempt purpose (an "unrelated business activity"). This tax is called the Unrelated Business Income Tax, or UBIT.

Unless an exception applies, a tax-exempt 501(c)(3) organization is subject to UBIT on income which is (i) derived from a trade or business; (ii) regularly carried on; and (iii) not substantially related to the performance of the organization's exempt purpose.[4] Each element of the definition must be met in order for the income to be subject to UBIT.

(a) Trade or Business

An activity is considered a "trade or business" if it **is carried on for the production of income** – e.g. in order to earn a profit.[5] By definition, all revenue generating activities will meet the first prong because their objective is to earn a profit and raise money for the organization.

(b) Regularly Carried On

A business activity is "regularly carried on" if it **occurs with a frequency and continuity similar to comparable commercial activities** of nonexempt organizations.[6] If a for-profit

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[3] The exemption from income tax and rules regarding UBIT generally apply to all tax-exempt organizations. A 501(c)(3) organization is unique in that it may also receive tax-deductible donations from the public.
[4] I.R.C. §§ 512(a), 513(a); Treas. Reg. §§ 1.512(a)-1(a), 1.513-1(a).
[5] *United States v. Am. B. Endowment*, 477 U.S. 105, 110, note 1 (1986); *see Carolinas Farm & Power Equipment Dealers Ass'n. Inc. v. United States*, 699 F.2d 167, 170 (4th Cir. 1983).
[6] Treas. Reg. § 1.513-1(c)(1).

business normally conducts an income-generating activity on a year-round basis, conducting the same business over a period of just a few weeks per year would not be regular carrying on of a trade or business. For example, selling sandwiches at a state fair for two weeks would not be a business "regularly carried on."

However, if the business activities are normally undertaken on a seasonal basis (e.g., sale of holiday cards), then the same activity conducted by a tax-exempt organization for a few weeks per year would be considered "regularly carried on."[7]

(c) Not Related to Exempt Purpose

Usually, the hardest question to answer is whether the business activity is **related to the organization's exempt purpose**—e.g. the organization's mission and activities as described in its articles of incorporation and original tax-exemption application (Form 1023). The term "substantially related" requires a causal connection between the business activities and an organization's tax-exempt purposes "[T]he performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes," but must contribute beyond simply fundraising to support the exempt purposes.[8] Examples of businesses the IRS has considered to be related to an exempt purpose include operation of a beauty shop by a senior citizens' center where many of the customers served had physical impairments making it difficult to travel[9] or charging admission for performances at a children's theater school.[10] Simply putting a nonprofit's logo on an item does not automatically render the sale of the item in furtherance of an exempt purpose.[11]

In determining whether a business activity is substantially related, the IRS looks at the size and extent of the activity compared to the nature and extent of the exempt function the business claims to serve.[12] For example, in 1973, the IRS ruled that income from the manufacturing and sale of toy products as part of a job training program was not subject to UBIT because the training program was not "conducted on a larger scale than [was] reasonably necessary to accomplish the organization's charitable purpose."[13] The nonprofit's mission was to provide educational and vocational training to nonskilled persons who were unable to find employment. The toy business was staffed primarily by unskilled individuals in an economically depressed community who were unemployed or under-employed and received on-the-job training while working for the toy business. The IRS stressed that the trainees were not hired as permanent

[7] Treas. Reg. § 1.513-1(c)(2)(i).
[8] *Id.* at § 1.513-1(d)(2).
[9] Rev. Rul. 81-61, 1981-1 C.B. 355.
[10] Treas. Reg. § 1.513-1(d)(4)(i), Example 1.
[11] However, there may be circumstances where selling items with an organization's logo is a related business activity. For example, if the purpose of an organization is to raise awareness about an issue and the placement of the logo helps raise the awareness, it is possible that the sale of the items may not be subject to UBIT. *See* I.R.S. P.L.R. 200722028.
[12] Treas. Reg. § 1.513-1(d)(3).
[13] Rev. Rul. 73-128, 1973-1 C.B. 222.

workers and that the organization made efforts to place them in permanent positions in the community as soon as they were trained.

In order to determine whether a revenue generating activity furthers an exempt purpose, the organization should look at 1) the specific purpose clause of its articles of incorporation, and 2) its narrative description of activities in its original tax-exemption application (Form 1023). If the proposed activity does not clearly fit within the organization's stated exempt purposes, but the activity is still charitable or educational (for example, a new fee-for-service program), the organization could still engage in the activity, and the revenues from the activity would not be subject to UBIT if the organization amends the specific purpose clause of its articles of incorporation to encompass the new activity. The organization should also inform the IRS and Franchise Tax Board (FTB) of its new programs on its annual return.[14]

Often a nonprofit will engage in a variety of revenue generating activities, some of which are related to an organization's exempt purpose and some of which are not. The IRS evaluates each activity in isolation, separate from the nonprofits other activities, to determine whether it constitutes a taxable trade or business – this is known as the "fragmentation rule."[15] For example, the IRS has determined that the use of a tax-exempt university's golf course by its students and employees was not an unrelated business, but its use by alumni and major donors was unrelated because there was no direct causal relationship between the educational purposes of the university and the use of the facility by those individuals.[16] In another example, the IRS ruled that the sale of grantmaking services by a community foundation to small private foundations serving the same geographic area was a related business, while sales of administrative and clerical services were unrelated businesses.[17]

As you can see from the examples above, the question of whether a business activity is in furtherance of an exempt purpose (and if not, therefore potentially subject to UBIT) requires an inquiry into the exempt purpose of the organization and an analysis as to whether and how the activity advances that purpose.[18] This requires careful analysis of the specific facts and

[14] For information on how to notify governmental agencies on a change in purpose or new scope of activities, *see* Public Counsel, *Notification Requirements for California Public Benefit Corporations: Change of Address, Name, Mission or Specific Purpose, Scope of Activities, or Other Significant Changes to Bylaws* (Dec. 2016), https://publiccounsel.org/publications/notification-requirements-for-california-public-benefit-corporations-change-of-address-name-mission-or-specific-purpose-scope-of-activities-or-other-significant-changes-to-bylaws/.

[15] I.R.C. § 513(c); *see* Treas. Reg. § 1.513-1(b).

[16] I.R.S. P.L.R. 9645004.

[17] I.R.S. P.L.R. 200832027. The IRS reasoned that the grantmaking services, which included assisting with establishing a grantmaking program, reviewing grant requests, preparing research in specific grantmaking areas of interest, and identifying opportunities for collaborating with other funders, would further the organization's exempt purpose of issuing grants to support charitable activities that benefit the citizens of the geographical area served by the community foundation. Conversely, the IRS concluded that the clerical and administrative services are routinely conducted by all organizations and did not require special knowledge of the charitable community served by the foundation

[18] Treas. Reg. § 1.513-1(d)(2).

circumstances, and we therefore recommend that organizations contact a lawyer for advice on whether a proposed revenue-generating activity would be subject to UBIT.

UBIT Exceptions

There are multiple exceptions for types of income to which UBIT does not apply. Common ones include income from:

- Activities in which substantially all of the work is performed by volunteers.[19]
- Sale of donated goods[20] – for example, a charity auction where the items have been donated. Note that sales tax may apply.
- Businesses carried on primarily for the convenience of members, students, patients, officers, or employees – for example, hospital gift shops, museum eating facilities, and coin operated laundry facilities in a college dorm.[21]
- Exchanging or renting of donor mailing list with another organization exempt from taxation under section 501(c)(3).[22]
- Dividends and interest.[23]
- Royalty payments.[24] However, income from services provided in connection with a royalty payment will be subject to UBIT.[25] If possible, a nonprofit should look into separating the revenue streams (i.e., separate the payment for services from royalty payments) to minimize UBIT.
- Rental income from real property.[26]
- Gains from the sale, exchange, or other disposition of capital gain property.[27]
- Bingo, if carried out in accordance with IRS rules.[28] There may be state and/or local regulation of bingo as a fundraising activity.

Many of these exceptions themselves have exceptions. For one, income derived from debt-financed property – e.g., rental income from property subject to a mortgage or income from stocks bought on margin – will be subject to UBIT to the extent that the property is debt financed (unless of course the property is being used to further an organization's exempt purpose).[29] Further, all income derived from stock in an S corporation, including interest and capital gains, will be subject to UBIT.[30]

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[19] I.R.C. § 513(a)(1).
[20] *Id.* at § 513(a)(3).
[21] *Id.* at § 513(a)(2); Treas. Reg. § 1.513-2(b).
[22] I.R.C. § 513(h)(1)(B).
[23] *Id.* at § 512(b)(1).
[24] *Id.* at § 512(b)(2).
[25] *Sierra Club, Inc. v. Comm'r.*, 86 F.3d 1526, 1532 (9th Cir. 1996).
[26] I.R.C. § 512(b)(3).
[27] *Id.* at § 512(b)(5).
[28] *Id.* at § 513(f).
[29] *Id.*. § 512(b)(4).
[30] *Id.* at § 512(e).

While passive income (royalties, rental income, interest, etc.) is generally exempt from UBIT, income from a taxable entity controlled by the nonprofit is subject to income tax to the extent that the payment is deductible by the controlled entity. An entity is "controlled" if the nonprofit owns 50% or more of the stock, profit or capital interests, or beneficial interests in the entity.[31] Since interest, rent, and royalty payments are usually deducted from income by a taxpayer, a nonprofit receiving these types of payments from a controlled taxable entity will generally have to pay UBIT on the income.

In addition to the exceptions for debt-financed property and income from controlled entities, there are other complications with respect to the rental income exclusion. The exclusion does not apply if the amount of rent depends on the income or profits derived by any person from the property lease (other than an amount based on a fixed percentage of gross receipt or sales).[32] Rents from personal property leased with real property is excluded, so long as the rents attributable to the personal property are incidental (i.e., no more than 10 percent); if more than 50 percent of the rent is attributable to personal property, the entire exclusion (including rental income from real property) is lost.[33]

The exceptions to UBIT—as well as the exceptions to those exceptions—are complicated and fact-specific. Please consult with an attorney or tax advisor regarding any questions about whether, and to what extent, an exception applies.

What about advertising and corporate sponsorships?

Questions often arise regarding whether advertising and/or seeking corporate sponsorships leads to unrelated taxable business income. "Advertising" includes messages containing qualitative or comparative language, price information, endorsements, or an inducement to purchase, sell, or use the products or services. Income from advertising regularly carried on is subject to UBIT.

In contrast, "qualified sponsorship payments" are not subject to UBIT. A "qualified sponsorship payment" is a payment with no expectation or arrangement that the payor will receive a substantial benefit in return, other than the use/acknowledgment of the business name, logo, or product lines in connection with the organization.[34] Therefore, receiving a donation in return for placing a sponsor's logo on a nonprofit's website[35] or on an invitation to a fundraising dinner will not ordinarily result in taxable income to the nonprofit. However, if the sponsor receives something in return, such as advertising beyond mere acknowledgement or an exclusive provider agreement, then the payment is <u>not</u> a qualified sponsorship payment and may be subject to UBIT unless another exception applies. Another example: while displaying a company's logo behind the stage at an annual dinner would likely be a qualified sponsorship payment, a promotional

[31] *Id.* at § 512(b)(13).
[32] *Id.* at § 512 (b)(3)(B)(ii).
[33] *Id.* at § 512(b)(3); Treas. Reg. § 1.512(b)-1(c)(2).
[34] *Id.* at § 513(i)(2)(A); Treas. Reg. § 1.513-4(c)(1).
[35] Treas. Reg. § 1.513-4(f), Example 11.

video advertising the company's products would be considered advertising (and would likely be subject to UBIT if regularly carried on).

What if our organization owes UBIT?

Organizations that owe UBIT will be taxed at the corporate rate and may take advantage of business deductions that are directly connected with the carrying on of the taxable trade or business. Until recently, a nonprofit with multiple lines of business could aggregate profits and losses on the various businesses and pay tax on the resulting income. Starting in 2018, losses of one business activity cannot be used to offset profits from another, which may result in more unrelated business taxable income for an organization than in previous years.[36] For this reason, tax-exempt organizations with multiple lines of unrelated business may choose to place unrelated business activity in a taxable corporate subsidiary in order to minimize tax liability (by offsetting profits and losses across lines of unrelated business).

The IRS allows a specific deduction of $1,000 for unrelated business taxable income – organizations earning less than $1,000 in an unrelated trade or business will not have to pay any UBIT. [37] If an organization determines that it has gross income of $1,000 or more from an unrelated trade or business (even if it ultimately does not owe any UBIT), it must file IRS Form 990-T, Exempt Organization Business Income Tax Return. Like for-profit corporations, tax-exempt organizations must make quarterly estimated payments of the tax on their unrelated business income. Please contact a tax advisor if your organization has any questions on how to pay UBIT.

Preserving Tax-Exempt Status

If a charity engages in substantial activities unrelated to its tax-exempt purpose, it may jeopardize its overall tax-exempt status. A 501(c)(3) organization must be "organized and operated" for an exempt purpose (e.g., charitable, educational, etc.).[38] Once activities unrelated to exempt purposes involve a substantial amount of an organization's resources or they produce a substantial amount of income, then the tax-exempt status of the organization may be in jeopardy if the unrelated activity is "substantial."

Unfortunately, there is no specific percentage of time or resources (e.g. a "safe harbor") that can be spent on unrelated business activities without jeopardizing tax-exempt status. The determination of whether unrelated activities are substantial depends heavily on particular facts and circumstances.[39]

- In one case, a court ruled that an organization was no longer tax-exempt because it expended just over 20% of its annual receipts on non-exempt programs.[40]

[36] I.R.C. § 512(a)(6).
[37] *Id.* at § 512(b)(12).
[38] Treas. Reg. § 1.501(c)(3)-1(a).
[39] *Nationalist Movement v. Comm'r,* 102 T.C. 558, 589 (Tax Court 1994).
[40] *Church in Bos. v. Comm'r*, 71 T.C. 102, 108 (Tax Court 1978).

- Yet in another, the IRS ruled that although an exempt organization derived 98% of its income from an unrelated business, the organization was tax-exempt because 41% of its activities in terms of expenditure of time constituted exempt programs and therefore the resources spent on the exempt activities was commensurate in scope with the organization's financial resources.[41]

Even if an organization's unrelated business activities are substantial, the organization can preserve its tax-exempt status by placing the business activities in a wholly or partially owned subsidiary.[42] For-profit subsidiaries are discussed in further detail below.

Limiting Liability

As with any new program, a nonprofit should assess whether proposed new activities may subject the organization to additional liability if, for example, someone were injured as a result of the activities or if the nonprofit were unable to meet obligations under its contracts. A nonprofit should contact its insurance broker to find out whether the new activities are covered under its existing insurance, and if not, whether purchasing additional insurance is advisable. A nonprofit should also consider contacting a lawyer to determine whether it can limit its liability for injuries to customers or purchasers through contractual means, such as indemnification provisions or liability waivers.

One way to minimize liability would be to place the business activities in a subsidiary, such as a corporation or LLC. Generally, the owners and directors of a corporation or LLC have limited liability, which means that they are not personally liable for any of the debts of the subsidiary beyond the value of their investment. Subject to several exceptions, if someone were to sue a for-profit subsidiary of a tax-exempt organization, the tax-exempt organization would not be held liable (although the plaintiff could certainly name it in a lawsuit). However, limited liability can be lost and the nonprofit parent held responsible if the nonprofit and the subsidiary are not operating separately from one another. In order to preserve limited liability, the nonprofit should take steps to ensure that it is operating as a distinct entity from the subsidiary by avoiding the commingling of funds, observing corporate formalities (appointing directors, holding meetings, keeping minutes, etc.), and contributing sufficient capital to run the corporation.[43]

Structure of Revenue Generating Activities

A nonprofit organization must give careful consideration as to how it should structure its revenue generating activities. The key issues in determining which structure is most appropriate are: (1) limitation of liability; (2) maintenance of tax-exempt status; (3) maximizing after-tax income and return on investment; (4) avoiding taxation, if possible; and (5) organizational ease (i.e.,

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[41] I.R.S. P.L.R. 9711003. *See e.g.* Rev. Rul. 64-182, 1964-1 C.B. 186. (requiring that an organization's exempt purpose activities be "reasonably commensurate" with its resources).
[42] I.R.S. P.L.R. 9119060; I.R.S. P.L.R. 8606056; *see Moline Properties, Inc. v. Comm'r,* 319 U.S. 436, 438-439 (1943).
[43] *Misik v. D'Arco*, 130 Cal. Rptr. 3d. 123, 129 (Ct. App. 2011).

minimizing complicated and expensive requirements, filings, etc.). Various options are discussed in further detail below. The Appendix contains a flowchart outlining different options.

Run Activities Within the Nonprofit

The simplest option for an organization looking to undertake a revenue-generating activity is to house the activity within the nonprofit. An advantage to this approach is that it is a good way to test the waters and determine whether the activities are viable and profitable before expending organizational resources to start a new entity. In addition, the business could freely use the nonprofit's name and goodwill, as well as assets and staff, without entering into licensing or cost-sharing agreements.

Operating the activities directly from within the nonprofit is only a good option if (1) the activities are related to the organization's exempt purpose, or if unrelated, not substantial in relation to the nonprofit's exempt activities; (2) the activities do not pose any unique liability risks that cannot be adequately mitigated through insurance or other means, such as contractual provisions; and (3) the nonprofit has no intention of raising money from investors to fund the business. A nonprofit with multiple lines of unrelated businesses should contact a tax advisor to determine if placing the businesses in a corporate subsidiary would result in more after-tax income for the organization by aggregating profits and losses from multiple lines of unrelated business.

For-Profit Subsidiary Corporation

A corporate subsidiary is a separate, taxable, corporation that is owned or partially owned by a nonprofit. Tax-exempt organizations may have one or more for-profit subsidiaries, including a corporation. The subsidiary corporation's income will be taxable at the normal corporate rate like any other for-profit business. In California, a corporation has to pay a minimum franchise tax of $800, regardless of income.[44] Any after-tax profits can be distributed to the shareholders (including the nonprofit parent) in the form of dividends. These dividends generally would not result in taxable income to the nonprofit because they are passive income exempt from UBIT. Other income derived from the subsidiary corporation – such as interest, rent, or royalties – may be taxable as unrelated business income if the nonprofit owns 50% or more of the interests of the corporation.[45]

A corporate subsidiary is a useful structure if an organization is worried about preserving its tax-exempt status. The activities of a corporate subsidiary are not attributable to its parent (the nonprofit owner) for tax purposes. Therefore, regardless of the volume of business done by the subsidiary, a nonprofit parent can preserve its tax-exempt status so long as the subsidiary has a real and separate business function and is not merely an instrumentality of the corporate parent. The nonprofit and the subsidiary should have separate bank accounts, keep separate books and records, conduct separate board meetings, and reimburse one another for services and use of

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[44] Cal. Rev. & Tax. Code § 23153(d)(1); *Corporations*, California Franchise Tax Board, https://www.ftb.ca.gov/file/business/types/corporations/index.html (last visited May 6, 2021).
[45] *See* note 31 and accompanying text.

resources at fair market value.[46] While not strictly necessary to avoid attribution, consideration should be given to differentiating the subsidiary's board of directors and officers from the parent-nonprofit's board of directors and officers.[47]

Another advantage to a corporate subsidiary is that shareholders (including the nonprofit owner) of corporations have limited liability and will not be held liable for the debts of the corporation as long as the subsidiary is structured as a distinct entity.[48] A corporate subsidiary may also be a useful mechanism to reduce income tax where a nonprofit has more than one unrelated business as tax-exempt organizations may no longer aggregate profits and losses from multiple businesses.

There are situations where a corporate subsidiary would not be appropriate. If the revenue generating activities are related to an organization's exempt purpose, or are otherwise not subject to UBIT, then placing the activities in a separate taxable corporation would impose income tax on activities that would not be taxable if housed within the nonprofit. Further, setting up a corporation can be expensive and most likely would involve the use of an attorney – if the nature and volume of the activities do not raise concerns about liability or loss of tax-exempt status, it may make more sense to operate the activities from within the nonprofit, rather than within a corporate subsidiary.

Limited Liability Company (LLC) and Partnership

Both partnerships and LLCs are pass-through entities for income tax purposes. Unlike a corporation, LLCs and partnerships do not pay income taxes. Instead, the partners and the members of the LLCs are taxed directly on their allocated share of the profit and loss of the LLC or partnership. An LLC differs from a partnership in one crucial manner – the owners of an LLC (called members) have limited liability for the debts of the LLC. In contrast, general partners of a partnership do not have limited liability, but instead are liable for the debts and obligations of the partnership and may have to personally contribute additional capital if necessary. In a limited partnership, the limited partner has limited liability, but does not have authority to run the business; the limited partner's role is more akin to that of a passive investor.

A partnership must have at least two partners, while an LLC can be single-member (one owner) or multi-member (more than one owner). Unless the owner affirmatively chooses otherwise, the IRS treats a single-member LLC as "disregarded" for income tax purposes – in other words, the LLC does not file an income tax return and is not treated as separate from its owner. A multi-member LLC by default is treated as a partnership for income tax purposes – the partnership is considered a separate entity and must file an annual return, although the partners are taxed on their shares of the income and loss of the partnership on their personal tax returns.[49] LLCs and

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[46] *Moline,* supra note 42; I.R.S. P.L.R. 201503018; I.R.S. P.L.R. 8606056; *see* I.R.S. P.L.R. 199938041; *see also Skarda v. Comm'r*, 250 F.2d 429, 434-35 (10th Cir. 1957); *see generally* I.R.S. P.L.R. 9119060.
[47] *See* I.R.S. G.C.M. 39,598.
[48] *See* note 43 and accompanying text.
[49] Treas. Reg. § 301.7701-3(b)(1).

limited partnerships are subject to California's $800 minimum franchise tax. LLCs with income of $250,000 or greater are also required to pay a fee based on annual income.[50]

The activities of partnerships and LLCs are attributed to the tax-exempt parent for purposes of determining whether the nonprofit parent is operating exclusively for tax-exempt purposes and whether the nonprofit parent has engaged in an unrelated trade or business.[51] For this reason, neither an LLC nor a partnership is a suitable structuring option if the revenue generating activities are unrelated to an organization's exempt purpose and are expected to be substantial, as the organization may lose its tax-exempt status. An LLC may be useful if the activities do not threaten an organization's tax-exempt status but (1) the activities pose unique liability concerns that cannot be adequately addressed through insurance, contracts, and other means; or (2) the nonprofit organization wants to raise money from outside investors or co-own the business with another nonprofit.[52]

With regard to bringing in for-profit investors into a partnership or multi-member LLC, if the activities of the partnership/LLC are not a substantial part of the organization's activities, a nonprofit's continued qualification for exemption under section 501(c)(3) will not be affected.[53] If the partnership activities are substantial, then a 501(c)(3) organization may participate in a partnership or LLC if (1) participation in the partnership furthers a charitable purpose; and (2) the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partner.[54] To the latter point, the partnership must be structured so that the nonprofit has enough control to ensure that the partnership actually furthers charitable purposes and does not overly benefit the for-profit partner.[55]

LLCs have a more flexible management structure than corporations. For example, LLCs do not need a board of directors. Instead, members of an LLC decide how the entity will be operated and governed through the LLC's articles of organization and operating agreement. Maintaining limited liability of LLC members does not require the observance of corporate formalities such as holding board meetings or keeping minutes; however, as with a corporation, an LLC member must avoid commingling funds with the LLC, contribute sufficient capital to create and operate the business, and refrain from using the LLC's assets as its own.

An LLC may choose to be treated as a *corporation for tax purposes* – this is known as "checking the box."[56] If the LLC checks the box, its members will have limited liability under state law *and*

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[50] *Partnerships*, California Franchise Tax Board, https://www.ftb.ca.gov/file/business/types/partnerships.html, (last visited May 6, 2021); *Limited liability company*, California Franchise Tax Board, https://www.ftb.ca.gov/file/business/types/limited-liability-company/index.html (last visited May 6, 2021).
[51] I.R.C. § 512(c); Rev. Rul. 2004-51, 2004-1 C.B. 974.
[52] There are limited circumstances under which a partnership is the suitable structure for a revenue generating activity. Please contact an attorney before creating a partnership with a for-profit entity.
[53] Rev. Rul. 2004-51, 2004-1 C.B. 974. Of course the nonprofit may have to pay UBIT if the activities are unrelated.
[54] Rev. Rul. 98-15, 1998-1 C.B. 718; I.R.S. G.C.M. 39,005.
[55] *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 236-237 (5th Cir. 2003).
[56] *See generally* Treas. Reg. § 301.7701-3.

the IRS will treat the entity as a corporation and tax it directly. The activities of the LLC would not be attributed to the tax-exempt owner and the owner's tax-exempt status will not be jeopardized. A "check the box" LLC is very similar to a corporation, with one potential advantage of an LLC being that it provides more flexibility to members/owners with respect to governance matters than a corporation provides to its shareholders. The choice between a corporation and a check-the-box LLC often depends on the preferences of the investors and the standards of the industry.

S Corporation

An S corporation is a corporation that elects to pass corporate income, loss, deductions, and credits to the shareholders. Shareholders of S corporations report their pro rata share of the corporation's income and losses on their personal tax returns and are assessed tax at their individual income rates. An S corporation provides limited liability to shareholders without the double taxation of a traditional C corporation.[57] As discussed above, all income received from an S corporation is subject to UBIT, even if the business of the S corporation is substantially related to the organization's exempt purpose or the income is of the type normally exempted from UBIT.[58] Therefore, an S corporation is not a useful structure for a for-profit subsidiary if the underlying income would not normally be subject to UBIT, as it would convert nontaxable income into taxable income. Further, S corporations cannot be owned by for-profit corporations or LLCs, and so the options for outside investment may be limited.

Setting up a Subsidiary and Taking on Investors

After a nonprofit determines that it should operate its revenue generating activities within a subsidiary and determines the appropriate form,[59] it should retain an attorney to help create the subsidiary. Once the subsidiary is formed, the nonprofit must then transfer the assets of the business to the subsidiary in return for shares of stock (if a corporation) or membership interests (if an LLC). If the subsidiary is wholly owned by the organization, then the organization will own 100% of the stock or membership interest and will be able to exert control over the subsidiary through its shares or interests.

In approving the transfer of assets to the subsidiary, the board of directors should ensure that the amount of assets that are transferred is reasonable in light of the planned activities of the subsidiary – shifting excessive charitable resources to a subsidiary may violate directors'

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[57] Although an S corporation is a pass-through entity, the for-profit activities of the S corporation are not attributable to the nonprofit parent I.R.S. P.L.R. 201328035; *see Moline, supra* note 42 (holding that corporation respected as entity separate from its owner for federal tax purposes); *see also* I.R.S. C.C.A. 201747006 (stating that *Moline* applies to S corporations); *see also* I.R.S. P.L.R. 201441018.

[58] *See* note 30 and accompanying text.

[59] Note that the decision whether to form a subsidiary takes place throughout the life of an activity. A related business activity that is appropriately carried out within a nonprofit may in time become an unrelated business activity as circumstances change. For example, a business run by trainees might in time retain those experienced employees and not seek new trainees. The business might then be subject to UBIT and could jeopardize the nonprofit's charitable tax-exempt status if not placed in a subsidiary.

fiduciary duties to the nonprofit corporation and be found to be an impermissible private benefit (in this case, to the subsidiary). Once the taxable subsidiary grows in value and generates income, the nonprofit should use the assets in the subsidiary to fund exempt programs, rather than let the assets accumulate. The IRS has stated that the growth of a for-profit subsidiary "presents a continuing obligation [to] translate this valuable asset into funds" for the expansion of exempt activities and that a nonprofit parent "cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable . . . activities." For example, the nonprofit parent may need to sell a portion of the subsidiary's assets or stock to fund exempt programs.[60]

The tax-exempt parent and taxable subsidiary may share resources, such as staff, equipment, and office space, without adverse consequences to the exempt parent. However, any costs incurred by either organization chargeable to the other must be valued at fair market value and allocated based on actual use. These payments will eliminate the contention that the organizations are actually one entity and that charitable funds are being expended for non-charitable purposes. Employees of a for-profit subsidiary may be included in employee benefit plans of the nonprofit owner, so long as the costs are allocated between the exempt organization and taxable subsidiaries on an equal per capita basis.[61]

If the subsidiary is partially owned by outside investors, a tax-exempt organization must ensure that the investor is paying a fair price in exchange for an ownership piece in the business – it may be necessary to obtain a third-party valuation of the business in order to set a fair price. If an investor is also an "insider" (e.g., director, officer, major donor, founder, etc.) or a business entity owned by an insider, the nonprofit parent needs to make sure it is not engaging in self-dealing or private inurement. "Private inurement" occurs when an insider to a charity unfairly or unreasonably benefits from a charity's assets or income – for example, if a senior manager of a nonprofit invested in a subsidiary partially owned by the nonprofit and paid less than the fair market value for her share of the subsidiary. Private inurement is prohibited by the IRS and could subject a nonprofit organization to excise taxes, and in some cases, loss of tax-exempt status.[62]

Conclusion

Revenue generating activities are a useful way for a nonprofit to raise money and potentially advance its mission. However, as discussed in this publication, revenue generating activities raise a host of legal issues that a nonprofit organization should address, preferably with the

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[60] I.R.S. P.L.R. 200437040.
[61] I.R.S. P.L.R. 9242039.
[62] A nonprofit organization should also consider whether the investment from an insider would be considered self-dealing under California Nonprofit Corporation Law. A self-dealing transaction is one in which the nonprofit is a party and in which a director (or a family member of a director) has a material financial interest (e.g., sale of shares of stock of a nonprofit's for-profit subsidiary to a director). Self-dealing transactions are only permissible if fair and reasonable to the nonprofit and approved by the board following specific procedures. Cal. Corp. Code § 5233(a), (d)(2).

assistance of an attorney and prior to launching a new activity. If you have legal questions related to any existing or proposed revenue generating activities, please contact Public Counsel at:

Public Counsel
Community Development Project
610 S. Ardmore Ave.
Los Angeles, CA 90005
(213) 385-2977

Appendix: Revenue Generating Activity Structuring Flowchart

Note: Determinations made under this flowchart will require advice of an attorney or other tax professional. Do not rely on this flowchart as legal advice.